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What do Trump's reelection, Fed rate cuts mean for small-caps?
By Rob Burgess
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The news last week that Republican Donald Trump had been reelected had an immediate positive effect on the stock market, especially small-cap stocks.

On Nov. 6, the day after Election Day, the Russell 2000 Index rose 5.8% while the large-cap Russell 1000 Index and the mega-cap Russell Top 50 Index were each up 2.7%. According to an analysis by Francis Gannon, co-chief investment officer of Royce Investment Partners in New York City, these were the 27th highest daily returns since the small-cap index's inception on New Year's Eve 1978.

"In the spirit of bipartisanship, we note that small-cap's robust record following elections has been remarkably consistent, with impressive strength regardless of which party or policy goals were in the ascendant," wrote Gannon. "This tells us that small-cap's post-election record has been driven more by psychology than ideology. Once elections are decided, investors feel they can see a more certain course ahead than before ballots were cast."

The electoral news was followed on Nov. 7 by the announcement that the Federal Reserve was cutting interest rates another 25 basis points. Taking a historical view, small-caps beat large-caps in the three-, six-, and 12-month periods following Fed rate reductions — and averaged double-digit returns in each period, wrote Gannon.

"However obvious, it's also worth pointing out that history seldom repeats itself," he wrote in his analysis. "Yet we find the persistence of small-caps' advantage over large-cap following both rate cuts and elections quite striking."

Other experts and advisors say they are cautiously optimistic about the future of small-caps in the coming years.

Continued rate cuts mean a changed playing field
Small-caps can offer significant growth potential, especially when markets are expected to grow, said Maxim Manturov, head of investment research at online broker Freedom24. With the reelection of Donald Trump and ongoing Fed rate cuts, he said he sees an opportunity for small-caps to perform well, he said.

"Since lower rates often mean cheaper borrowing for smaller companies, it can help them grow," he said.

Tushar Kumar, private wealth advisor at Twin Peaks Wealth Advisors in San Francisco, said the recent rate cuts have indeed shifted the positioning of this asset class.

"We've increased our exposure to small-cap stocks, as these companies tend to benefit from lower rates," he said. "Many small-cap firms operate with floating-rate debt structures, so a reduction in interest rates directly lowers their financing costs."

The anticipated effect of a second Trump term

On the political front, a Republican-led agenda could ease regulatory pressures, which would likely favor smaller companies, said Kumar.

"While larger firms typically have the resources to navigate compliance challenges, smaller firms may see a competitive edge with reduced regulatory burdens," he said.

It is still early days in determining the actual impacts of the most recent election, but financial markets have shown considerable volatility "as rumor confronts reality," said Jordan Irving, portfolio manager for Glenmede Investment Management in Philadelphia.

"The election results likely pave the way for diminished bureaucracy and the possibility for a more robust economic cycle," he said. "If this is the case, a rate-cutting regime will be less impactful for small caps as pent-up investments, M&A and the simple business cycle should allow the asset class to inflect higher."

With Trump's reelection on a so-called America First agenda, Michael L. Rosenberg, managing director at Diversified Investment Strategies in Floram Park, New Jersey, said he believes small businesses are well-positioned to benefit from this policy focus.

"Increased domestic manufacturing should create more opportunities for small companies, as production shifts back to the U.S.," he said. "Additionally, reduced business taxes will allow these companies to retain more earnings, which they can reinvest for growth and innovation. A favorable interest rate environment, coupled with tax incentives, will also provide small businesses with attractive borrowing conditions, enabling them to expand operations and fuel further economic growth."

However, Gannon wrote, there are concerns, including regarding tariffs, "which have historically been inflationary, tamping down demand."

"The timing and reach of tariffs are developments we'll be watching closely — and management teams of many holdings have been surveying as best they can the possibility of an altered global trading landscape," he wrote.

Align portfolios with client risk tolerance

In general, small-cap funds are a valuable tool for diversification and offer the potential for higher returns, but they need to be carefully sized within a portfolio based on an investor's risk tolerance, said Kumar.

"All in all, we're optimistic about small-cap performance in the near term, given both the economic and political landscape," he said.

Manturov said he still positions small-cap funds as a strong growth component in client portfolios, particularly for those with a higher risk tolerance. Looking forward, he said he expects small caps to benefit from a growing economy and rate cuts.

"That said, investors have to be very selective," he said. "Although strong small-cap picks usually have solid financial health and a competitive edge in their industry, anything can happen. … I'd stay cautious with small caps in highly volatile or speculative sectors, where market conditions can quickly impact their performance. Keeping a balanced approach is key."

Small-cap funds have indeed had an interesting few years, said Landon Buzzerd, associate wealth advisor at Grant Street Asset Management in Canonsburg, Pennsylvania. And while he said believes they deserve an allocation in a portfolio, Buzzerd warned that the quality of the companies has declined due to the rapid growth of private equity.

"Good small companies are staying private longer because they receive their capital from private equity firms and do not need to go public to raise funds," he said. "We prefer to lean towards more quality companies in the small-cap space, regardless of if that exposure is accomplished through an ETF, mutual fund or private equity."

While small caps have had a strong trailing year and have outperformed their large-cap peers, Irving said he believes there could be more to come.

"If one looks at the trailing three years performance results relative to large-caps, it is apparent how much ground there is yet to be recovered," he said. "Small-cap valuations remain attractive relative to their large-cap peers and asset allocations to small caps remain well below historic levels. … Our approach to small-cap investing has not changed as a result of the election because we invest with a two- to three-year time frame and, therefore, do not attempt to invest around specific events."